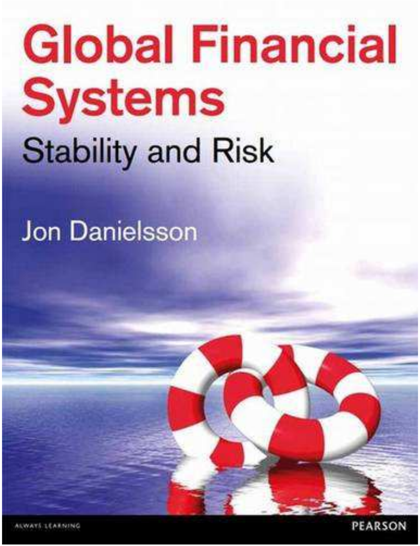
# Global Financial Systems
# Chapter 19
# Sovereign Debt Crises

Jon Danielsson London School of Economics


To accompany
*Global Financial Systems: Stability and Risk*
`http://www.globalfinancialsystems.org/`
Published by Pearson 2013

Version 5.0, August 2018

# Book and slides




- The tables and graphs are the same as in the book
- See the book for references to original data sources
- Updated versions of the slides can be downloaded from the book web page

`www.globalfinancialsystems.org`

# Chapter 19 and 20

- These slides contain the first part of Chapter 19

# Sovereign Debt

# Sovereign debt

- Sovereign debt is money owned by a *sovereign authority*
  - e.g. central government or central bank
  - not municipal government or government–owned firms
  - *unless* they have an explicit central government guarantee
- Two types
  1. Domestic debt
  2. External debt
- The failure of government to pay back its debt in full is called a *sovereign default*
- But keep in mind it is not same as a private default (discussed below)

# External debt

- Debt owed to foreigners in *foreign currency* under *foreign law*
- Direct issue in *capital market* or borrowing from *commercial banks*

# Domestic debt

- Domestic debt has always been a major part of a country's debt stock, averaging almost *two-thirds* of total public debt in the 20$^{\text{th}}$ century
- Advanced economies issue mainly domestic debt because thy can borrow in their *own* currency without having to pay a risk premium
- Domestic debt gives governments more options to default *indirectly* on their debt
- By creating *inflation*, governments can lower the real value of their debt stock
    - Like the US did in 1947 and may do now
    - QE

# What about European sovereign debt?

- Issued in domestic currency
- In some countries mostly held by foreigners, in others by domestic agents
- Subject to domestic law (86% of Greek debt)
  - The Greek "nuclear option"
  - Only Athens issued debt was haircut, not London issued debt
- Distinction depends on context

# Sovereign default

- Inherently *different* from the bankruptcy of a company
- *Countries do not go bust*
- A default is the result of a *cost–benefit calculation* of the government involving economic, financial, political and social aspects
- Most country defaults happen long before a nation really runs out of resources
- No *legal framework* exists for sovereign defaults, no clearly drawn up *rights* for creditors, no *supranational institutions*
- Repayment depends therefore not only on the *ability* of the government but also on its *willingness* to do so

# History

- Sovereign defaults have been *common*
- France defaulted *8* times from 1500–1799
- Spain defaulted *7* times in the 19$^{th}$ century after having defaulted *6* times in the preceding three centuries
- Today's developed countries almost exclusively experienced external defaults when they were developing
- Only after the WWII did the developed countries stop being serial defaulters
- With newly gained *independence*, developing countries started to default frequently
- In the 20$^{th}$ century, India defaulted *4* times, Indonesia *5* times, and Brazil *7* times

# Defaults, restructuring, rescheduling

- *Default is usually restructuring*
- Often involves swapping a high interest rate for a lower interest rate and occasionally even a reduction of principal

# External defaults

- An external default is strongly correlated with *global economic factors*, especially commodity prices, interest rates and capital flows because sovereign borrowing is *procyclical*
- When capital inflows suddenly *reverse*, developing countries frequently slip into default
- Countries tend to *overborrow* in good times, leaving them vulnerable when conditions worsen

# Why repay sovereign debt?

- Reputation risk — curtailment of future access to capital markets may be more costly
- Disruption to trade, like trade financing and enforcement of claims in friendly jurisdictions
- Discouragement of FDI — a country that defaults less likely to respect creditors rights
- Reputation costs are significant but short–lived
- Why is Venezuela still repaying debt? Oil shipments and foreign assets (cf. Citgo)

# Debt tolerance

- How can some countries function with 240% debt to GDP (Japan, see below)
- While others default at 40%?

Even though a lot of commentary focuses on debt/GDP, that is not as relevant as some other variables indicating the ability to service debt, for example debt/foreign income.

# Debt intolerance

- *Weak institutional structures* and a *problematic political system* make external borrowing a tempting device for governments to employ to *avoid* tough decisions
- But safe debt thresholds depend heavily on a country's record of default and inflation
- A country's debt intolerance can be determined by its *repayment history*, *indebtedness level*, and *history of macroeconomic stability*

# Japan

- Japan borrows in Yen, long–term debt held by domestic agents and carries $\approx 0\%$ interest. Hence tolerates 240%
  - Note however it causes serious problems. For example, it cannot risk inflation because that would raise interest rates which then could trigger default — deflation

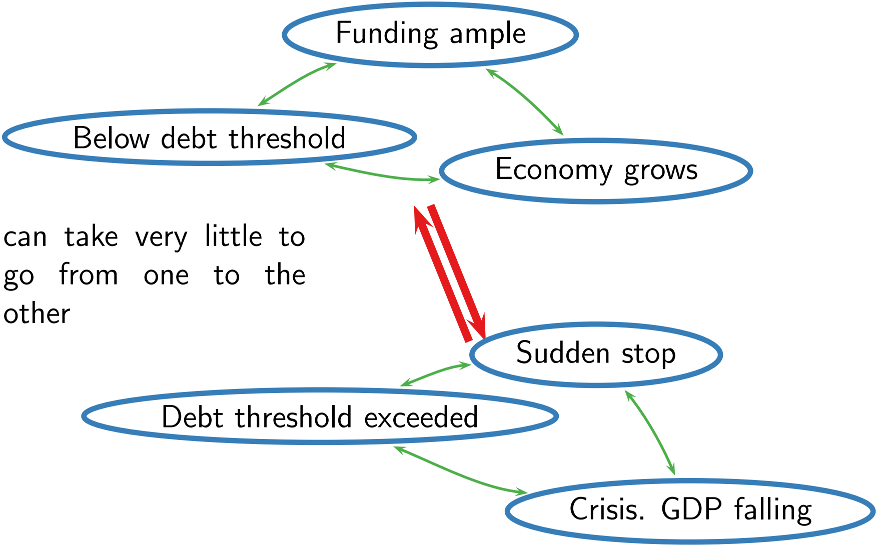
# Some others

- While other countries borrow in foreign currency, at short maturities, held by skittish investors
- Mexico defaulted in 1982 at 47%
- Argentina in 2001 at 50%
- Exceeding 100% only a factor in 16% of defaults (1970–2008)
- Half below 60%, 20% below 40%
- Threshold is dependent on the history of the country
- A serial defaulter, with weak institutions, persistent inflation, citizens inured to crises has a low threshold
- Note the endogeneity

# Vulnerabilities

- Many countries tend to satisfy their funding needs by *borrowing short–term*, issuing debt with maturities between one to three years, which carries a *lower interest rate*
- This introduces *roll–over risk* and makes a country vulnerable to a *liquidity crisis*
- Many emerging markets issue mainly *external* sovereign debt
- This introduces *exchange–rate risk* and makes a *devaluation* more costly

# Vulnerabilities




can take very little to go from one to the other

# Enforcement

# Domestic and foreign issues

- Debt issued at home under domestic law
- Can legally be changed and even repudiated (act of parliament)
  - Greeces "Nuclear option"
- Foreigners usually insist on foreign courts (New York or London)
  - Think Argentina

# Institutions

- There are no international courts for enforcing sovereign debt
- Some institutions exist (next slide)
- But generally requires different approaches from corporate debt
- The IMF has proposed creating international legal system for sovereign debt, almost universally rejected

# Paris club

- Finance ministry officials from 19 of the largest countries
- Meet in Paris
- Specialized financial services like restructuring, relief and cancellation
- A last resort for indebted poor countries
- Recent examples: Nigeria, Liberia, Democratic Republic of Congo

# Military enforcement

- Egypt reneged in 1882, UK invaded and made it a British "*protectorate*"
- A few years before, the British had invaded Istanbul in 1876 in the wake of Turkey's default
- US intervention in Venezuela in the 1890s and the occupation of Haiti in 1915 partly motivated by debt repayment concerns

# Newfoundland

- Only liquidation of a country for debt reasons
- By 1933 its public debt was about three times its GDP and industry collapsed
- Government asked UK for help who responded "No part of the British Empire has ever yet defaulted on its loan obligations" ... "bankruptcy is at best an ugly word and carries a stigma which a nation even more than an individual would do well to avoid."
- Newfoundland to temporarily give up its independence to a dictatorship
- 2 referenda in 1949
- Forcibly merged with Canada

# Extreme legal steps and vulture funds

- Sovereign debt can live for years, even centuries (e.g., Haiti and Russia)
- May attract vulture funds

> " billionaire Paul Singer, who in 1996 paid $11m for discounted Peruvian debt and then threatened to bankrupt the country unless they paid him $58m ... In order to keep a good standing in international financial markets Peru paid. Singer and his New York–based investment fund, Elliot Associates, have since sued the Republic of Congo (Congo Brazzaville) for $400m for a debt bought at $10m."
>
> Guardian newspaper 2007

- Argentina and Elliot 2012

# Carrots and sticks

- Creditors can stretch out maturities and raise interest rates to contract cost of haircut. Credit enhancements
- May violate existing covenants and pari passu (next slide)
- Sovereign can threaten default, and in all recent cases either suspended or threatened default to bring creditors to table

# Encouraging lenders to agree

- *Exit consents*, bondholders that agree to restructuring, give the sovereign a proxy vote that may strip away valuable features of old bonds, making them less attractive to holdouts. This often only requires a simple majority of bondholders
- *Collective action clauses* (CAC), that permit the majority, or supermajority, of creditors to modify key features of the terms of bonds, including principal and interest payments

# History lessons

## Lee C. Buchheit

a. Don't let a sovereign debt problem become a banking crisis
b. Don't delay recognizing that debt levels are unsustainable
c. Keep track of government obligations (especially local government, Argentina, Spain, China)
d. Ask for enough relief (avoid repeats, Latin America, Greece)
e. Be ruthlessly efficient. Sovereign debt crisis, come along with other problems that need addressing
f. Be evenhanded and treat all creditors is same (except perhaps trade credit). Resist geopolitics and long–term promises